



**EXAMINATION OF SELECTED ACTIVITIES OF THE  
KENTUCKY RACING HEALTH AND WELFARE FUND, INC.**

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EDWARD B. HATCHETT, JR.  
AUDITOR OF PUBLIC ACCOUNTS

January 22, 2003

Don Ball, Chairman  
Kentucky Racing Health and Welfare Fund, Inc.  
2912 South 4<sup>th</sup> Street  
Louisville, Kentucky 40215

Frank Shoop, Chairman  
Kentucky Racing Commission  
4063 Iron Works Pike, Building B  
Lexington, Kentucky 40511

RE: Examination Report of the Kentucky Racing Health and Welfare Fund, Inc.

Gentlemen:

At the request of the Kentucky Racing Commission, we have examined selected issues of the Kentucky Racing Health and Welfare Fund, Inc. (Fund). The results of our examination and our accompanying recommendations are reported herewith.

Our examination focused primarily on the Fund's investment practices and on its development of the Heywood School building into a residential facility for eligible beneficiaries of the Fund. Our procedures included analyzing documents and data provided by the Fund. We also interviewed current and former Fund directors, employees of the Fund and the Commission, various professionals providing services to the Fund, and others.

We wish to thank current and former members of the Fund's Board of Directors, the Kentucky Racing Commission, Fund staff, and all others involved for their cooperation during the course of our examination.

Very truly yours,

A handwritten signature in dark ink, appearing to read "Ed Hatchett".

Edward B. Hatchett, Jr.  
Auditor of Public Accounts

EBHJr:kct





## Introduction

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In 1978 the General Assembly authorized the establishment of the Kentucky Racing Health and Welfare Fund, Inc. (Fund) as a non-profit charitable corporation. The purpose of the Fund is to benefit racing personnel employed in connection with thoroughbred racing, and their spouses and children, who can demonstrate a need for financial assistance connected with death, illness, or off-the-job injury and are not otherwise covered by union health and welfare plans, workers' compensation, social security, public welfare or any type of health, medical, death, or accident insurance.

KRS 230.374 reads as follows:

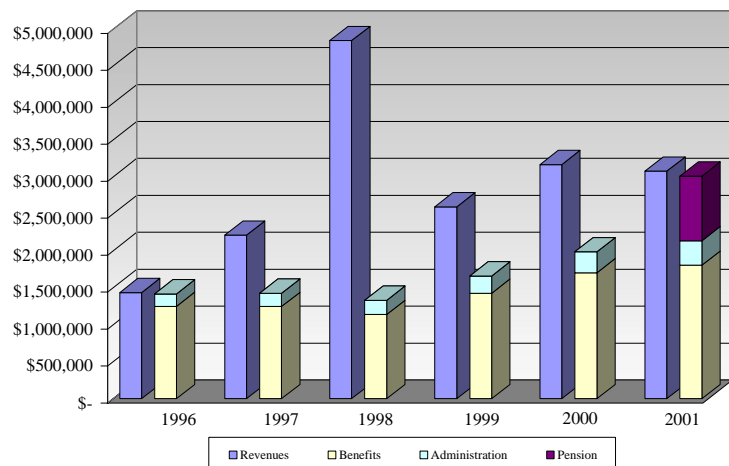
All sums reported and paid to the commission under the provisions of KRS 230.361 to 230.373, with the exception of funds paid under KRS 230.398, shall be paid by the commission to the Kentucky Racing Health and Welfare Fund, Inc., a nonprofit charitable corporation, organized for the benefit, aid, assistance, and relief of thoroughbred owners, trainers, jockeys, valets, exercise riders, grooms, stable attendants, pari-mutuel clerks, and other thoroughbred racing personnel employed in connection with racing, and their spouses and children, who can demonstrate their need for financial assistance connected with death, illness, or off-the-job injury and are not otherwise covered by union health and welfare plans, workers' compensation, Social Security, public welfare, or any type of health, medical, death, or accident insurance. These sums shall be paid on or before December 31 in each year, however, no payments shall be made by the commission to the Kentucky Racing Health and Welfare Fund, Inc., unless the commission and the Auditor of Public Accounts are satisfied that the fund is in all respects being operated for the charitable and benevolent purposes as set forth in this section and that no part of the funds paid to the fund by the commission or any net earnings of the fund inure to the benefit of any private individual, director, officer, or member of the fund or any of the persons who turned over sums to the commission representing unclaimed pari-mutuel tickets.

The Fund, in accordance with its bylaws, is governed by a four-member Board of Directors (Board). The Board consists of two elected officers of the Kentucky Horsemen's Benevolent and Protective Association (KHBPA), an appointee of the Governor, and an appointee of the Kentucky Racing Commission (Commission).

Annually, the Fund receives a sum representing the total amount of unclaimed pari-mutuel tickets from all thoroughbred wagering in Kentucky. In accordance with KRS Chapter 230, these amounts are remitted to the Commission and, in turn, the Commission forwards the money to the Fund. Until 1989, receipts of the Fund were modest – less than \$500,000 annually. With the implementation of off-track betting and simulcast wagering, receipts from unclaimed pari-mutuel tickets have grown to more than \$2.8 million in each of the last two years.

Paid benefits and administrative expenses of the Fund have risen as more racing personnel have taken advantage of the allowable benefits. The Fund reported claims totaling \$1,805,462 paid on behalf of 1,052 eligible beneficiaries in 2001. This is a 45% increase from the \$1,247,973 paid on behalf of 841 eligible beneficiaries in 1996.

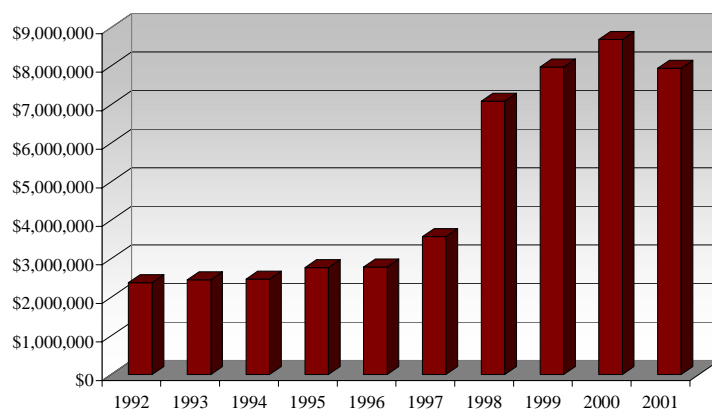
**Revenues and Expenses by Type**





The annual receipts from the unclaimed tickets and interest income are significantly greater than the benefits paid, resulting in a substantial fund balance. Also, in 1998, a reduction in the required holding period for unclaimed tickets allowed the fund to receive an additional year's receipt of over \$2 million. By December 31, 2000, the accumulated cash and investment balance of the Fund was more than \$8.6 million, enough to provide several years of charitable benefits.

**Growth in Fund Balance**



In response to this infusion of funding, in late 1998 and early 1999, the Fund began exploring ways to expand its benevolent mission. Specifically, the Fund sought the means to

- Establish a pension benefit for backside employees and other racing personnel;
- Purchase and operate a residential facility for retired racing employees; and,
- Invest a portion of its reserve fund in equities.

The Board sought authority from the 2000 General Assembly to allow the Fund to contribute money to a pension plan for backside employees. The General Assembly passed the legislation, codified as KRS 230.375, which enabled the Fund to create the Kentucky Race Track Retirement plan. This statute authorizes the Fund to contribute up to 25 percent of its annual unclaimed pari-mutuel ticket receipts to the retirement plan.

The Fund, through its general counsel, sought opinions from the Kentucky Attorney General (AG) to determine whether the Fund could purchase residential property and invest funds in equities. The AG responded in May 1999 that the Fund was not precluded from owning residential property so long as the property was used for the Fund's charitable purpose. In August 1999, the AG wrote that since the Fund was not a local government unit or political subdivision, it was not subject to the investment restrictions of KRS 66.480.

## Findings and Recommendations

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### **The Board sought to improve investment rate of return by investing in common stocks.**

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At the end of 1998, the Fund held investments in excess of \$6.8 million, predominantly invested in U.S. Treasury securities. The Board became interested in diversifying its portfolio to improve the return on investments.

By the end of 1999, the Fund's investments had grown to over \$7.9 million. U.S. Treasury notes comprised over \$7 million of these investments; the remainder was in Federal Home Loan Mortgage instruments, corporate bonds, and money market funds. The market yield of the Fund's portfolio at December 31, 1999, was 6.172 percent.

*The Board requested an opinion from the AG regarding applicability of investment statute.*

In March 1999, the Fund's general counsel, on behalf of the Board, wrote the AG requesting an opinion on the applicability of KRS 66.480 to the investments of the Fund. KRS 66.480 limits on the types of investments allowed for public funds by local governmental units. The statute does not allow investments in equities such as common stocks. The general counsel's letter stated "[p]resently, the Fund holds its assets in investments returning income significantly below other current market returns. The Board of Directors of the Fund is investigating permissible alternatives to its present investment strategy."

The Fund's general counsel argued that KRS 66.480 did not apply to the Fund since the Fund's monies were private and since the Fund was not a local governmental unit or political subdivision. The AG responded on August 30, 1999, with a letter that opined the Fund's monies did contain public funds since "the money is held by a state agency for a public purpose, and the state agency is responsible for its proper disbursement."

The AG concluded, however, that "we believe a court would likely determine that KRS 66.480 does not apply to the Fund because the Fund does not appear to be a 'local governmental unit' or a 'political subdivision' as defined in KRS 66.480." The letter cautioned, however, "please be advised that we have not addressed whether the limitations contained in KRS 42.500 *et seq* or any other limitations (e.g. fiduciary duties) may apply to investments made by the Fund and/or its directors, as your question does not broach those issues. Also there is nothing that would prohibit the Commission from developing an MOE with the Fund to define investment guidelines since the Commission has an interest in Fund performance and security."

*The response of the AG was discussed at the September 1999 Board Meeting.*

The Board minutes of September 1, 1999, state "Mr. Benson [General Counsel] reported that he had received a favorable opinion from the Kentucky Attorney General which would allow the Fund to invest in equities." While the Board and the Commission shared a common member at the time, there is no indication that the full Commission was advised of the AG's response or took any official resulting action. There was no formal initiative by the Board to seek investment guidelines from the Commission.

The Board solicited, received, and evaluated proposals from ten investment firms and in March 2000 selected one firm to manage its investments. In April 2000, the Fund began investing in equities and split its investment account into two accounts: 1) an operating account comprised of funds budgeted for direct and indirect health benefits, the residential facility, and the track pension benefit; and 2) an asset reserve account to fund traditional and more aggressive investments.

This reserve account initially received nearly \$4.8 million, 60 percent of the Fund's total balance of approximately \$8 million. Within the reserve account, \$1,197,184 was invested in equities. This represented 25 percent of the reserve account, in accordance with the Fund's investment policy.

*The Fund has lost over \$632,000 as a result of investing in equities.*

The stocks purchased and sold by the investment firm have resulted in realized losses to the Fund in excess of \$431,000 through December 2002. In addition, unrealized losses on the equities held at December 31, 2002, total over \$201,000. During this same period, the Fund's reserve account investments in money market and bond funds earned over \$470,000.

The Fund's current investment policy maintains the equity portion of its portfolio at about 20 percent of the total market value of the reserve account. As these equity investments have diminished in value, more money has been reallocated from the Fund's more stable investments in money market funds and bond funds to purchase additional equities.

*Kentucky Racing Health and Welfare Fund*

*Summary of Equity Investment Activity  
April 2000 through December 2002*

	<u>Purchases</u>	<u>Sales</u>
2000	\$ 1,498,359	\$301,170
2001	639,837	473,065
2002	<u>978,180</u>	<u>764,594</u>
Totals	\$ <u>3,116,376</u>	\$ <u>1,538,829</u>

Net Investment	\$ <u>1,577,547</u>
Market Value 12-31-2002	<u>944,652</u>
Loss on investments	\$ <u>632,895</u>

Since April 2000, a net total of \$1,577,547 has been invested in equities. The market value of these investments at December 31, 2002, was \$944,652. This represents a loss of 40 percent of the total equity investment of the Fund. By comparison, the benchmark Standard and Poors 500 Index also declined by 39 percent, and the Dow Jones Industrial Average declined by 22 percent during the same time period.

The investment bank managing the Fund's reserve account charges an asset management fee of one-tenth of one percent of the account's value annually. This fee totaled approximately \$13,000 for the 32 month period examined.

The Fund's bylaws state the Board shall conduct its business "in close cooperation with the Kentucky Racing Commission." In furtherance of this policy, better formal communication should exist between the Board and the Commission. The limitations on the investment of public funds, though not statutorily applicable to the Fund, were established to prevent the type of principal losses suffered by the Fund during the past 32 months. As the AG's response stated, "the Commission has an interest in Fund performance and security."

*Recommendations*

We recommend the Fund work with the Commission to review the Fund's investment policy, with focus on the fiduciary duties inherent in managing public funds. Further, we recommend the Fund modify its investment strategy, as necessary, to preserve investment capital during volatile market conditions.

**The Fund decided to purchase and renovate the Heywood building to be used as a residential facility.**

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In May 1999, the Fund's general counsel received a response from the AG that stated the Fund could own residential property if it was used for the Fund's charitable purpose. In anticipation of a favorable opinion, the Fund had been seeking suitable property near Churchill Downs to house older and retired backside workers. The Board subsequently authorized the Chairman and Vice Chairman to negotiate for the purchase of the Heywood building, a former elementary school built in 1903 and vacant since 1988.

*The Board anticipated no more than \$1 million invested in the project by the Fund.*

The Board's discussion of the project cost is described in the minutes of September 22, 2000. According to these minutes, the total cost of purchase and rehabilitation would be approximately \$4.5 million. The minutes state "[o]f that amount, \$3.5 million will be paid through historic tax credits, housing tax credits, and [City of Louisville HOME] grant money. The remaining \$1 million will be paid by the Fund either out right or by securing a loan. Either way, the rental income from the facility would pay back the \$1 million to the Fund, resulting in a net cost of zero with the Fund taking title to a \$4.5 million project."

Throughout our examination, those interviewed consistently told us that the Board expected the Fund's investment in the project would not exceed \$1 million. Our analysis indicates that under current obligations, the Fund will have more than \$1 million invested in the project when, and if, the Fund eventually takes title to the property. Further, the Fund's investment in the property may ultimately exceed the market value of the property.

*The Fund's ultimate investment in the project will possibly be greater than the market value of the property.*

An independent appraiser stated in a February 2002 report: "because the costs of construction dramatically exceed the market value of the property, the project is only feasible because of the equity generated from the sale of low income housing tax credits to an investor and from favorable financing."

Two types of federal tax credits were applied for and secured: the Low Income Housing Tax Credit (LIHTC) and the Rehabilitation Tax Credit.

The federal government offers the LIHTC as an incentive for developers to build affordable rental housing. The Rehabilitation Tax Credit is a federal incentive for the preservation of historic buildings. Non-profit developers can take advantage of these incentives by "selling" the credits to for-profit investors. This is accomplished by entering into corporate arrangements with investors, who buy into the project. With the equity contribution from the investing member, the non-profit developer or associated managing member can proceed with developing the project.

*The equity investor, a publicly traded corporation, will receive tax benefits through credits and depreciation-derived losses.*

The equity investor in turn receives tax credits in an amount greater than its investment, providing an adequate return over the life of the investor's involvement in the project. The equity investor also benefits from depreciation-derived operating losses generated by the project, thus further reducing the investor's tax liability. Investors in LIHTC projects, because of alternate minimum tax rules under the federal tax code, are typically only widely-held, publicly-traded C corporations.

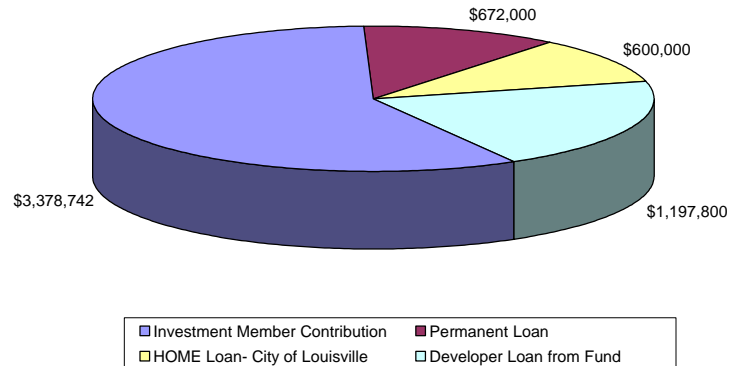
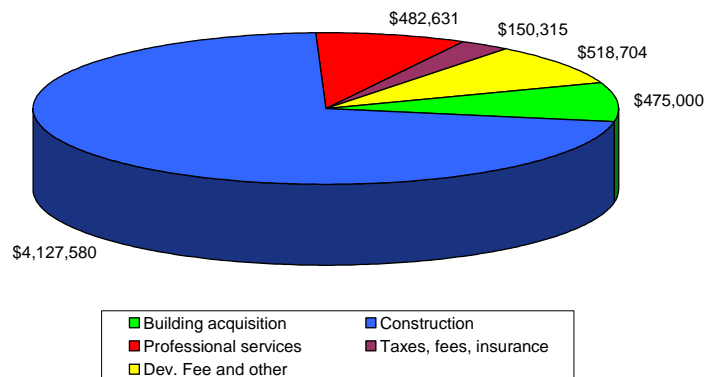
As is typical in projects involving tax credits, the Fund established a separate non-profit corporation, Backtrack Inc. (Backtrack), and a limited liability company, The Old School, LLC. The Old School, LLC owns the building and Backtrack manages Old School, LLC. An equity investor, arranged for independently by a tax credit syndicator, owns 99.99 percent of Old School, LLC.

The four initial directors of Backtrack, Inc. were the same individuals who comprised the Fund's Board of Directors. The Board's chairman is the president of Backtrack, Inc. The bylaws of Backtrack, Inc., specify that its directors coincide with the Fund's.

*The current project cost estimate is \$5.75 million.*

The total cost of the project has grown to approximately \$5.75 million, financed through nearly \$3.4 million in capital contributions from the tax credit investor, and a variety of loans to Old School, LLC totaling more than \$2.4 million. These loans include:

- 1) A "permanent" first mortgage loan from a local bank in the amount of \$672,000. Monthly payments will be made on the permanent loan for 15 years, leaving a principal balance of \$439,000 at the end of the loan period.
- 2) A second mortgage loan from the City of Louisville, using federal HOME funds, in the amount of \$600,000. We note that this HOME money is structured as a loan, not a grant as the Fund anticipated at the September 2000 Fund Board meeting. No payments are required on this mortgage for 15 years, after which the terms of the loan may be renegotiated. Should the City demand repayment, as is currently expected, the principle and compound interest amount due will have grown to \$1,378,085.
- 3) A third mortgage loan from the Fund in the amount of \$1,197,800. After 15 years, at the note's terms of 4 percent simple interest, the balance of the note will be \$1,916,480.

**Sources of Project Financing****Project Costs of Backtrack Apartments**

*An independent appraisal estimated the market value of the completed building at \$840,000.*

The lending bank required a prospective market value appraisal of the property. The appraiser, using an income capitalization approach, estimated the prospective market value of the property at \$840,000. The income capitalization approach used a projected net operating income of \$78,000 and an overall capitalization rate of 9.25 percent. The project's financing consultant has estimated annual net operating income will be significantly less, approximately \$56,000. This lower income projection would result in a proportionately lower prospective market value of about \$605,000.



*The Fund will have the right of first refusal to purchase the building in 2017, for the existing debt totaling \$3.7 million.*

After 15 years, the tax credit investor is expected to withdraw from Old School, LLC, at which time the LLC will offer the property to the Fund, under a right of first refusal, for an amount essentially equal to the total amount of the remaining debt. Should the Fund decide to assume ownership of the property in 2017, the Fund will have to pay off, refinance, seek loan forgiveness, or forgive debt totaling over \$3.7 million.

In terms of present value, the cost to the Fund to purchase the property in 2017 is over \$2 million. This includes its current \$1,197,800 loan to the Old School, LLC, the \$600,000 HOME loan from the City of Louisville, and the present value, estimated at \$230,000, of the 2017 principal balance of the permanent loan.

The Fund's consultant has projected a monthly rent of \$405 on the building's 18 efficiency apartments, averaging 335 square feet. A rent of \$431 was projected for the 22 one-bedroom units, which average 464 square feet. The appraisal noted that market rental rates in the area are below these restricted rent levels. Accordingly, the prospective market value of the property would not increase even if there were no restricted rent requirement. Regardless, the LIHTC rent restrictions are required for 30 years, limiting the Fund's revenue potential for 15 years after the withdrawal of the investment partner.

*A developer's fee rebate could reduce the Fund's effective investment by up to \$371,000.*

One component of the cost of the renovated building is the developer's fee. A portion of the developer's fee is an allowable addition to the basis of the building, which results in a higher investor contribution than if there were no such fee. Half of the developer's fee will be returned to the Fund, as developer, when the last installment from the tax credit investor is due. This amount of \$371,841, subject to reduction by unforeseen development expenses, is scheduled to be received by the Fund in October, 2003. This fee can be deemed to be a reduction of the Fund's investment in the project. If the Fund purchases the building, the present value of the Fund's investment in the project, net of the developer's fee, would be approximately \$1.6 million.

*The independent appraisal did not estimate a market value for the use of the building's first floor.*

Further, the prospective market value of the completed building, as estimated by the independent appraisal, did not attach a value to the first floor. The first floor, when completed, is intended to house the Fund's administrative offices, as well as a not-for-profit day-care center, and the offices of the KHBPA. The appraiser concluded "the potential clearly exists for additional market value attributable to the first floor." The Fund recently provided us with an appraisal estimating the market value of the first floor to be \$700,000. Once lease agreements for first floor space are finalized, information will be available that may impact the projected market value. The Fiscal Year 2000 financial statement audit of the KHBPA listed rent expense of \$400 per month. In addition, the Fund believes the market value could escalate due to neighborhood improvements in the Churchill Downs area.

The Fund contends that it will not buy the building in 15 years unless it believes the purchase to be in the best interest of the Fund, dependent primarily on the Fund's ability to secure sufficient loans, grants, and equity. The Fund has suggested that the permanent loan or the HOME loan, or both, could ultimately convert to grants, substantially reducing the Fund's financial obligation.

If the Fund does not exercise its right of first refusal to buy the building, the property will be offered for sale to a purchaser who will be required to continue the project under existing rent restrictions. Should the property sell for more than the remaining debt, the Fund will get its investment back, with 4 percent simple interest, and the excess will go to the tax credit investor. If the property sells for less than existing debt, the Fund will absorb the investment loss, since sale proceeds would first pay off the permanent loan and HOME loan.

In summary, the Fund may ultimately invest more money in the apartment project than its known revenue potential presently suggests it is worth. Conversely, several factors exist which could ultimately make the project financially favorable.

*Recommendations*

We recommend the General Assembly examine the Fund's mission and existing statutory authority to determine whether modifications should be made to further delineate the Fund's appropriate use of public funds for benevolent purposes.

We recommend the Fund formally notify the Commission and the Auditor of Public Accounts (APA) prior to initiating new benevolent programs using public funds so that the Commission and APA can fulfill their duties under KRS 230.374.

**The building must be used for the Fund's statutory purpose.**

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The Fund's governing statute defines the charitable purpose of the Fund. KRS 230.374 describes the intended beneficiaries as "thoroughbred racing personnel **employed** in connection with racing, and their spouses and children, who can demonstrate their need for financial assistance connected with death, illness, or off-the-job injury and are not otherwise covered by union health and welfare plans, workers' compensation, Social Security, public welfare, or any type of health, medical, death, or accident insurance." Emphasis added

The tenants of the building, as beneficiaries of the Fund's project, must meet this statutory definition. Accordingly, the tenants either must be employed in connection with racing or be their spouses and children, and must be needy due to death, illness, or off-the-job injury. The Fund's chairman and general counsel have assured us that the statutory requirements will be met.

The 2000 General Assembly authorized the Fund to create the Kentucky Race Track Retirement Plan under the provisions of KRS 230.375. This statute states "[t]he board members or any investment manager shall discharge their duties with respect to the assets of the plan solely in the interest of the plan's members and: (a) For the exclusive purposes of providing **benefits** to plan members and their beneficiaries..." Emphasis added. The Fund contends that the term "benefits", which is not defined in the statute, allows the Fund to provide housing to race track retirees as a plan benefit.

*A home for retired race track workers may not meet the Fund's statutory mandate.*

While housing benefits may comply with legislative intent, the statute links retirement benefits to assets of the Kentucky Race Track Retirement Plan. Accordingly, since the apartment building is not an asset of the Kentucky Race Track Retirement Plan, but rather as asset of The Old School, LLC, the Fund may need additional statutory authority. The Fund has not defined to us how distribution of this benefit will occur nor have we been apprised of specific occupancy guidelines. Thus it is impossible to determine at this time if there is adherence with statutory language and legislative intent.

*Board-approved assistance for living expenses has averaged \$17,000 per year.*

The Fund's Board-approved benefit guidelines allow for assistance for living expenses, including rent, to persons "while disabled or recovering from an incapacitating condition...." This benefit is limited to a maximum of \$500 for no more than six months. The Fund has provided financial assistance of this type averaging \$17,000 per year for the last three years.

*Tax credit restrictions preclude the exclusion of applicants unassociated with the racing industry.*

Federal fair housing requirements associated with the tax credits do not allow the Fund to exclude otherwise qualified housing applicants who are not connected with the racing industry. Conversely, to the extent any tenant of the apartments is not employed in racing, the Fund will be in violation of its statutory charitable purpose. The Fund has suggested that since the Fund's investment in the project, comprised of the \$1.197 million loan, is only twenty percent of the total cost of the project, as few as eight of the project's 40 units need be occupied by statutorily qualified tenants.

We believe the Fund's interest, as developer of the project, as the likely inheritor of \$3.7 million in debt 15 years hence, and as the creator of and controlling body over the managing member of the limited liability company that owns the building, is much more substantial than that. Further, an investment of this magnitude for the benefit of as few as eight eligible beneficiaries would be a poor fulfillment of the Fund's charitable purpose.

We recognize the great benevolent value of providing affordable housing to low-income elderly persons. There is no doubt many of the eventual tenants of the apartment building will find these living conditions far superior to those to which they are accustomed. We also recognize the intangible value of preserving a historic building, particularly within the framework of a neighborhood renaissance near one of horse racing's icons, Churchill Downs. Our obligation, however, is to examine the use of public funds against the criteria of KRS 230.374, which defines the charitable purpose of the Fund. The statute also states "no payments shall be made by the commission to the [Fund] unless the commission and the Auditor of Public Accounts are satisfied that the fund is in all respects being operated for the charitable and benevolent purposes as set forth in this section...."

### *Recommendations*

We recommend the legislature evaluate the Fund's interpretation of its enabling statutory language and provide guidance or clarification if there is a conflict between the Fund's interpretation and legislative intent.

We recommend the Fund ensure all tenants of the residential building comply with the Fund's statutory requirements for providing benevolent assistance, as well as comply with all other occupancy requirements set forth in agreements made to secure financing for the project. If the Fund wishes the project to serve a broader range of beneficiaries, the Fund should seek the necessary statutory revisions.

We recommend the legislature evaluate the funding process established in KRS 230.374 to assure the effective use of public funds while sustaining the benevolent purposes of the Fund.

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**KENTUCKY RACING HEALTH & WELFARE FUND  
RESPONSE TO AUDITOR'S REPORT**

January 17, 2003





## **INTRODUCTION AND COUNTER STATEMENT OF FACTS**

The staff and Board of Directors of the Fund wish to thank the Auditor and his staff for their diligence and professionalism during the conduct of this examination. While it is important to note, as detailed below, that we disagree and take issue with several elements of the findings contained in the draft report, we nevertheless generally concur with the recommendations made by the auditor.

The Fund has been and remains strongly committed to its benevolent and fiduciary responsibilities for those in the Kentucky Thoroughbred Racing industry who have little support elsewhere.

In 1998, legislation was passed which reduced the amount of time the tracks hold the money from two years to one year. As a result of that legislation, in 1998 the fund received what amounted to two years of uncashed tickets in one payment of \$4,667,545.

## **COUNTER STATEMENT OF FACTS**

1. The annual receipt of unclaimed tickets and interest income is not significantly greater than the benefits paid resulting in a substantial fund balance. As the amount of uncashed tickets has increased significantly, the amount of charitable benefits has increased just as significantly.

*Auditor's Reply: For the nine-year period 1993 through 2001, Fund income totaled in excess of \$20.8 million. Benefits paid by the Fund during the corresponding period total just over \$11.5 million. Administrative costs and recent pension contributions total approximately \$2.7 million. The Fund's balance of cash and investments has grown from \$2.4 million to nearly \$8 million during the same nine-year period.*

2. The Fund has seen a significant increase of 31 percent in demand for its services by the population it serves. In 1994, the Fund approved and paid for requests from 793 eligible individuals. By the year 2000, that amount had increased to 1,038 individuals.
3. The number of times that the Fund provided benefits (referred to as contacts) had a dramatic increase of 92 percent. In 1994, the Fund provided benefits for 1,763 contacts (the Fund provided benefits for each eligible individual and/or his dependents a total of 2.22 times during the year). By 2000, the number of contacts had increased to 3,379 contacts (provided benefits for each eligible individual and/or his dependents a total of 3.25 times during the year).
4. The auditor reports on page 5 that at the end of 1998 the Fund held investments in excess of \$6.8 million and by the end of 1999 the Fund's investment had grown to over \$7.9 million. The 1998 figure includes the amount of uncashed tickets that were to be used to operate the Fund during the following year which was \$2.4 million and should not be considered as part of the reserve investment. The 1999 figure includes the amount of uncashed tickets that were to be used to operate the Fund the following year which was \$2.8 million and should not be considered as part of the reserve investment.

5. The auditor further reports that the Fund held investments of \$8.6 million at the end of 2000 which would be enough to provide for several years of benefits. However, once again, that figure included the uncashed ticket grant of \$2.8 million which was totally used to operate the Fund in 2001 and should not be considered as part of the reserve investment. Further, on December 31, 2000, the Fund had an estimated \$164,000 in pending benefit payments.

The Fund's reserve has been less than two years budget for some time and continues to decline.

*Auditor's Reply: The Fund's investment holdings come directly from the independent audit reports prepared by the Fund's private auditor. KRS 230.374 requires the Commission to remit unclaimed ticket monies by December 31 of each year, and these sums are properly included in the year-end balances.*

*The decline of the Fund's reserve appears to be attributable to three factors: contributions to the Pension Fund, investment in the Heywood Building, and investment losses due to stock market declines.*

6. The Fund has continued to increase its benefits as uncashed tickets have increased. In 1988, the Fund provided benefits of 50 percent of actual charges with an annual maximum of \$4,000 from a limited menu of available medical services. In 2000, the Fund paid 100 percent with a maximum benefit of up to \$35,000 with a greatly expanded and proactive availability of benefits.

*Auditor's Reply: For the three-year period 1993 through 1995, benefits paid constituted 83 percent of the Fund's income. For the three-year period 1999 through 2001, benefits paid were only 56 percent of Fund income.*

7. In addition to the expanded maximum benefits and menu of services that the Fund provides, the Fund also experiences the continued steady increase in the cost of healthcare as documented in the March 2002 Time magazine article on healthcare costs:

"Healthcare costs in this country are soaring fueled by drug and hospital charges. Insurance premiums rose 11% last year and are likely to increase an additional 15% next year."

From 1995 to 2000, the amount the Fund spent on health benefits alone rose from \$1 million to \$1.7 million, an increase of 70 percent. Through November 2002, the Fund experienced an additional 27 percent increase in amounts spent on healthcare benefits.

8. In 1997, in the face of mounting -healthcare costs, the Fund established its "cost shifting campaign" in which the Fund made a concerted effort to negotiate contractual discounts for medical services; and negotiated the cost of medical billings on an individual basis with those providers that the Fund did not have a contract. From 1997 through 2000, the efforts of the cost shifting campaign, through the hard work of the staff, resulted in savings of \$2.9 million. Through November of 2002, the savings of the cost shifting campaign since its inception approached \$4 million. Every year that this effort has been in place, the savings have more than exceeded the entire administrative cost of operating the Fund. If not for these savings, the actual reserve **at the end of the year would be** \$2.9 million, less than one years operating revenue. For the past two years, the amount of uncashed tickets have remained stagnant at \$2.8 million while the cost of medical care and the number of claims that the Fund has experienced has continued to increase.
9. The board's sources through its cost shifting campaign to find alternative payors (Medicare, Medicaid, etc.) are drying up due to shortages of state and federal funds. A recent report by the National Governors Association showed that Medicaid and state employee health benefits make up about 30 percent of state spending. Those costs rose an average of 13 percent, the largest spike in a decade, according to the NGA's "Fiscal Survey of States." Raymond C. Scheppach, NGA executive director, said such growth is not sustainable and "You will see huge cuts in Medicaid" next year. States have \$14.5 billion on hand, a sharp decline from \$48.8 billion in 2000. Total state tax collection fell 6 percent last year, while spending grew 1.3 percent.
10. The Fund's reserve balance at the end of 2002 will be less than two years of operating and benefit expenses.

*Auditor's Reply: The Fund has failed to include the 2002 allotment of over \$2.8 million from the Commission, due by December 31, 2002. The annual allotment of unclaimed ticket money recently has exceeded yearly operating and benefit expenses by 30 percent or more.*

#### **AUDITOR'S AREA OF EXAMINATION #1**

*The Board sought to improve its investment rate of return by diversifying a limited portion of its reserve account*

## **RESPONSE TO FINDINGS AND RECOMMENDATIONS**

### **A. Response to Page 6, Paragraph 3**

*... the Fund had a common member and officer and an appointee of the Commission on its Board. (And) it had staff representation at meetings of the board at which the issues were discussed and materials such as the Attorney General's opinion were distributed and available.*

The board minutes of September 1, 1999 also show that in addition to the shared board member, the Kentucky Racing Commission was represented by Mr. Calvert Bratton, who at the time was employed by the Kentucky Racing Commission. He had served as the Commission's observer and liaison between the Kentucky Racing Health and Welfare Fund and the Commission. Also, the Kentucky Racing Commission is notified of every Fund board meeting, usually 60 days prior to the meeting. The Fund mails a copy of the minutes of all Fund board meetings to the Kentucky Racing Commission, usually 30 days prior to the next meeting. The Fund mails an agenda to the Kentucky Racing Commission usually within 14 days of the next meeting. The Fund expects to have a Commission observer present at its meetings. The Fund chairman, who serves as an appointee of the chairman of the Kentucky Racing Commission, always welcomes comments and input from the Kentucky Racing Commission observer, when one is present.

The Fund sends a copy of its annual audit to the Kentucky Racing Commission. The executive director of the Fund has attended most of the regularly scheduled meetings of the Kentucky Racing Commission since 1988. He has made several presentations before the Commission on behalf of the Fund and is always responsive to inquiries by the Commission.

The Commission regularly received copies of minutes from the Fund in addition to numerous phone contacts between the Fund and the Commission staffs.

*Auditor's Reply: We encourage strengthened communications between the Fund and the Commission. We believe better communication could have allowed the Commission to act on the Attorney General's suggestion to provide investment guidelines to the Fund.*

### **B. Response to Page 7, Paragraph 2**

From its inception in April 2000 until January 15, 2003, the reserve account has shown an actual increase in value of \$240,177.10. The PNC reserve account is professionally managed to specific guidelines established by the Fund, which are extremely conservative in nature and geared not for short-term investing or market fluctuations. As the Fund has not been reliant on the income earned from this investment in the past, it is not heavily impacted by any negative result in the performance of its investments over a short period of time.

*Undervalued stocks can and do recoup their losses (as indicated by the last two month's increase in market value). It would seem to be irrelevant to count the unrealized losses in the portfolio as LOST money.*

We believe there is something of an apples to pears comparison in regard to the auditors comments on the equity and bond performance. The report indicates that the equities have lost \$632,000 since inception. *If one includes the unrealized gain on the bond portfolio as of January 15, 2003 (\$240,177. 10), then the GAIN on the bond side of the account would be a total of \$791,399.00 and, in fact, has resulted in a positive return for the entire portfolio.*

Moreover, the market value of equity holdings has increased nicely since this summer's lows. With a January 15, 2003 market value of \$5,004,611.00, the account has recouped the values lost during the year on the equity side of the equation and actually leaves the account ahead of the beginning balance by \$240,178.00. *This dramatic move since October 2002 demonstrates the upside potential of the diversified investments by the Fund.*

So, while we share the Auditor's concern about the possible effects of volatile markets, we believe, as does the Fund's Professional Investment Manager, that the benefits of the long-term performance of the stock market far outstrips the risk. (Please see appendix for detailed information supporting this discussion.) Also, it is important to note that the statutes which guide the Legislative-Judicial Retirement Funds, the Kentucky Employees Retirement System, the County Employees Retirement System and the Kentucky Teachers Retirement System each specifically authorize investments in equities using public funds.

**Response to Auditor's Recommendation**

***The Fund will adopt the recommendation to work with the Commission in regard to the Fund's investment policy. And though we believe that the Fund has and is investing its assets wisely, we will continue to be vigilant toward the nature of the Fund's investments with an eye to long-term returns through prudent diversification.***

**AUDITOR'S AREA OF EXAMINATION #2**

***The Fund decided to purchase and renovate the Heywood building to be used as a residential facility.***

**The Residential Facility**

Housing has always been a concern for the beneficiaries of the Fund. Many live in stables, barns and tack rooms. Such conditions as these contribute to poor health and illness. As a result, the Fund undertook to provide a residential facility for their beneficiaries.

It is incorrect to say the board anticipated no more than \$1 million invested in the project. The board discussed and approved an investment of \$1,197,800. *There are no other financial obligations or commitments of the Fund to this project.* The other debt in the project is not the Fund's.

1. The Fund has a right of first refusal to purchase the property in fifteen years. This is a right of first refusal only and in no way obligates the Fund to purchase the property. The Fund has the right of refusal in order to protect its investment in the project of \$1,197,800. The Fund felt that it would be inappropriate and fiscally irresponsible to make an investment of this magnitude in the project without the ability (not the obligation) to protect its investment in the property at the end of the 15 year period. The Fund feels that it is being unfairly criticized for obtaining the right of first refusal. The Fund continues to feel that the right of first refusal is a fair and effective mechanism to protect its investment in the property and would only be exercised if it would be fiscally prudent based on the facts and circumstances that will exist in 15 years. The Fund feels that not having the ability to protect its investment and purchase the property in 15 years would be imprudent fiscal practice.
2. As the 15th year approaches, in accordance with prudent financial and investment practices, the Fund plans to have the property reappraised, evaluate the then-current interest rate environment, and explore the availability of grants, low interest rate loans, below-market rate interest rate loans, and all other financing and refinancing options available at that time. Only after all these factors are evaluated, and only if it is a prudent investment that makes economic sense, would the Fund purchase the property. The decision on whether or not to purchase the property will only be made after a thorough evaluation of all the surrounding facts and circumstances that exist in 15 years.

In 15 years, the Fund will make the prudent decision to acquire the facility or to have it sold with its mortgage paid or assumed by the Buyer.

The Fund has invested its \$1,197,800 with the belief that it is a worthwhile expenditure whether it is repaid or becomes a grant if it acquires the facility in 15 years.

## **RESPONSE TO FINDINGS AND RECOMMENDATIONS**

### **A. Response to Page 9, Paragraph 1**

The Board discussed and approved an investment of \$1,197,800. Currently the Fund has appraisals of \$1,540,000 for the facility, which exceeds its initial investment.

Obviously the appraised value of property 15 years in the future cannot be known. However, historically real property values increase over time, and while the Fund's investment may not ultimately exceed the value of the facility, it is very likely that in 15 years its value will be many times the Fund's investment.

### **B. Response to Page 9, Paragraph 2**

In order to obtain tax credits, a project must go through a rigorous process at Kentucky Housing Corporation where all of the applicants are scored and only those with the highest scores, representing the most needy projects, get the credits.

In almost all of tax credit projects, and this one in particular, the only way the proposed residents could afford quality housing is if a subsidy of some sort is involved. This is where the tax credits come in—they serve as a subsidy for the tenants. The most common subsidies involve the government giving cash (checks) or cash equivalents (vouchers) to needy individuals. Tax credits also serve as a subsidy, but in a completely different way. Instead of providing individuals with cash or cash equivalents to help them pay rent, tax credits pay for a portion of the construction cost, which means the owner/operator of the project will have less debt to service, and can then charge less for rent. Traditional subsidies give individuals cash or cash equivalents that enable them to pay market rate rents that the owner must charge to service a debt. Tax credits lower the construction costs, which lower the debt service, which lower the amount of rent that the owner/operator must charge in order to operate the project. The same goal is reached—lowering the amount of rent the tenant must pay out of its own pocket—but by completely different means.

Since one of the key components of determining the market value of an apartment complex is the cash flow from rents, in almost all tax credit projects, the construction costs will exceed (in some cases, dramatically) the market value of the project since construction costs are being subsidized to lower the owner/operator's debt service to enable the owner/operator to provide low income housing.

This is the underlying premise of the IRS Low Income Housing Tax Credit program. Affordable rents are not sufficient to support a loan great enough to develop housing. This statement fails to recognize that this is the intent of the financial structure of the development. It would be appropriate at this point to itemize the six values assigned by the appraiser:

\$ 475,000 as is value  
 \$ 840,000 income approach value, for 40 units  
 \$ 700,000 income approach value first floor offices  
 \$ 260,000 value of the preferred mortgage financing \$2,400,000 value of the tax credits  
 \$ 880,000 value of the historic credits  
 \$5,555,000 Total

*This statement as written leaves the reader to conclude that this is a poorly conceived transaction, which is not the case.*

***Auditor's Reply:*** *We take exception to the valuation methodology presented by the Fund in this response and maintain that the cost of the project does exceed the current identifiable value.*

**C. Response to Page 10, Paragraph 1**

The formation of ownership entities serves as protection to the Fund and is customary in all commercial real estate transactions.

**D. Response to Page 10, Paragraph 3**

The "cost" of the project for the Fund is \$1,197,800. For that investment, it has a \$5,555,000 low-income rental facility available to its beneficiaries for 30 years. The permanent loan is a below-market rate loan from Federal Home Loan Bank of Cincinnati (FHLB) via a local bank. FHLB's Affordable Housing Program is designed to help fund projects similar to the Old School.

**E. Response to Page 10, Paragraph 5**

The clause "... as is currently expected ..." is overstated as it is speculation. It is common practice that HOME funds are expected to be converted to grants and forgiven or renegotiated.

**F. Response to Page 12, Paragraph 2**

The Fund's only commitment to the project is the \$1,197,800 loan to the LLC. All other loans are to The Old School, LLC and do not encumber the Fund.

**G. Response to Page 12, Paragraph 3**

The final rents have not been determined.

**H. Response to Page 12, Paragraph 4**

The Fund's only commitment is the \$1,197,800 loan to the LLC. The payment of the developer's fee will be a reduction in the Fund's investment.

**I. Response to Page 13, Paragraph 3**

We believe this is not accurate according to the common understanding of the term "open market." Should the project be offered for sale, Kentucky Housing Corporation (KHC), as the IRS's representative, is required to seek a purchaser who will continue the affordability of the project. In so doing, KHC assists with the process and can bring resources to the table. This requirement is enforced by a recorded Extended Use Agreement and Deed Restriction.

**J. Response to Page 13, Paragraph 4**

Again, we must point out that the first sentence ignores the intent of the LIHTC program's purpose to provide affordable housing. It leads the reader to conclude that this is a flawed financial transaction, whereas it is structured exactly the same as hundreds of similar transactions in this country that for 16 years have fulfilled the intent of the IRS's 1966 Low Income Housing Program.



**Response to Auditor's Recommendation**

***The Fund has always been available and open to the General Assembly and will adopt this recommendation to continue to be in close contact with the General Assembly and to notify the Commission and the Auditor prior to initiating any new benevolent programs.***

**AUDITOR'S AREA OF EXAMINATION #3**

**The building must be used for the Fund's statutory purpose.**

**The Fund has and will follow all of its governing statutes.**

A significant portion of the draft findings and recommendations are premised upon the conclusion that "a home for retired racetrack workers would not meet the Fund's statutory mandate." This conclusion is based upon KRS 230.374, without reference to KRS 230.375. The latter statute, however, provides that the fund may create and fund the Kentucky Racetrack Retirement Plan using no more than 25 percent of the annual sums paid to the Commission pursuant to KRS 230.361-230.373. The retirement plan is to be "provided for the benefit of thoroughbred trainers, assistant trainers, exercise riders, grooms, stable attendants, and other stable employees who can demonstrate that they are not otherwise eligible to participate in any other public or private, non-self-funded retirement or pension plan." Further, "[t]he board members ... shall discharge their duties with respect to the assets of the plan solely in the interest of the plan's members and: (a) For the exclusive purpose of providing, benefits to plan members and their beneficiaries..." *"Benefits" as used in this statute are not defined and, consequently, are not limited to cash payments. The provision of retirement housing (whether free or partially subsidized) for eligible retired persons is entirely within the scope of authority granted by this statute. While expenditures for retirement housing and other retirement benefits would have to comply with the 25 percent limit set forth in the statute, this is a matter of plan administration. Although the Fund's intent is to market the units to its beneficiaries as defined in KRS 230.374, its governing statutes which include KRS 230.375 do not create the type of absolute prohibition reflected in the draft report.*<sup>1</sup>

<sup>1</sup> It is also significant to note that the legislature, in adopting KRS 230.375 in the 2000 Session, made the following provision with regard to funds which might be invested as a part of the retirement plan: "Investments shall be diversified to balance the risk associated with various investment: options to maintain the long-term solvency of the plan." Board members are required to discharge their duties ... "(b) with the care, skill, prudence and diligence under the circumstances that a prudent person acting in a like capacity and familiar with these matters could use in the conduct of an enterprise of like character and with like aims;..." This is a statutory codification of the "prudent man rule" which governs investments of private trust companies and other fiduciaries, pursuant to which investment strategies in diversified portfolios that include a significant percentage of equities (often as large as 60%) are almost universally upheld. This statutory language is strong evidence of the General Assembly's recognition that the Health and Welfare Fund is not subject to the restrictions applicable to units of local government and other entities contained in KRS 66.480.

**RESPONSE TO FINDINGS AND RECOMMENDATIONS**

**Response to Page 15, Paragraph 3**

We believe that this section trivializes the Fund's position that 20 percent of the tenants, or eight tenants, are assignable to the Fund's investment and concludes that this is a bad investment. The Fund's investment is \$1,197,800. That figure divided by 30 years (the rent restriction period) is

\$39,926 per year, which divided by 12 months and by eight tenants is \$415 per month. A rental assistance of \$415 per month could neither be considered a "magnitude" nor a "poor fulfillment" for individuals earning roughly \$10,000 per year.

*Auditor's Reply: This statement anticipates the Fund's purchase of the building after 15 years. As noted on page 12 of the report, the cost to the Fund to purchase the building at that time could be as much as \$3.7 million. The Fund's statement also ignores that its current investment of \$1,197,800 is all up front, not parceled out over 30 years.*

But the greater benefit is that the Fund will have 40 units available to its beneficiaries at any given time. It will have provided its beneficiaries a \$5.55 million renovated facility with only an investment of \$1,197,800 which may be repaid with interest in the future. These units will be available to its beneficiaries for years to come. *The Fund has no other financial obligation to the project other than this one time investment.* One cannot speculate 30 years in the future but a safe bet would be that this one time investment will provide housing for backside workers for a greater period of time than the initial 30-year period.

*Auditor's Reply: Again, if one assumes backside workers will be provided housing by this project for 30 years and more, that necessarily assumes the Fund's acquisition of the building, requiring additional investment by the Fund. The Fund's insistence that it has no other financial obligation to the project assumes the LLC's sale of the building in 15 years to a third party. At that point, the Fund would have no control over the tenancy of the building.*

By investing \$1,197,800 in the project and annualizing the investment over the 30-year period, the Fund will be able to provide \$166,560 in annual rental subsidy for an investment of only \$39,926 per year. This is roughly a 4-to-1 return on every dollar that the Fund has invested in the project. This is an extraordinary rate of return and shows the type of leverage and return on investment that tax credit deals produce.

*Auditor's Reply: The Fund is not providing a rental subsidy of \$166,560. That is the approximate annual amount of gross rental income the LLC will collect from the apartment tenants, not a provided subsidy. Net operating income, as stated in the report, is projected to be \$56,000 to \$78,000. This return, compared with the initial investment of \$1,197,800 and the likely additional costs associated with acquiring the building in 15 years, renders the financial soundness of the investment wholly dependent on factors unknown at this time.*

#### **Response to Auditor's Recommendation**

**The Fund's goal is for all tenants to meet the Fund's statutory guidelines. The Fund also agrees with the recommendations for continued dialogue with the Kentucky General Assembly.**

**APPENDIX: KENTUCKY RACING HEALTH & WELFARE FUND  
RESPONSE TO AUDITOR'S REPORT**

[Click Here for Appendix](#)

January 17, 2003

